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IN THE

Supreme Court of the United States

OCTOBER TERM, 1939.

No. [redacted] 5

HARRY H. NEUBERGER,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR REHEARING OF PETITION FOR CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Supplemental Memorandum for Petitioner.

JOSEPH M. PROSKAUER,
WALTER MENDELSOHN,
WILBUR H. FRIEDMAN,
Counsel for Petitioner.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1939.

No. 548.

HARRY H. NEUBERGER,
Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REHEARING OF PETITION FOR CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Supplemental Memorandum for Petitioner.

After the denial of certiorari in this case, a petition for rehearing was filed, together with a motion to defer consideration of the petition for rehearing until the decision of a pending case in the Court of Claims involving identical issues. The Court has not yet acted on the petition for rehearing or the motion to defer consideration thereof.

On February 5, 1940 the Court of Claims decided the case of *John Craik* v. *United States,* believed to be in conflict with the decision below and reprinted in full in appendix (*infra,* pp. 13-20). (The *Craik* case is not the case referred to in the petition for rehearing, which has not yet been decided by the Court of Claims. *Central Hanover Bank & Trust Co., et al., Executors* v. *United States.*) The *Craik* case was

called to the attention of this Court on February 10th, and on February 12th petitioner was notified by the Clerk that this supplemental memorandum would be received.

The conflict between the *Craik* case and the decision below is indicated by the following excerpts from the opinions of the Court of Claims and of the court below in *Johnston* v. *Commissioner* 86 F. (2d) 732, the Court below having decided this case on the authority of its earlier decision by a divided Court (Judge Swan dissenting) in the *Johnston* case:

Craik (Court of Claims).	*Johnston* (Second Circuit).
"We are convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually. If we are correct in this, then this plaintiff's proportionate share of the partnership income received from sources without the United States should be treated as though he himself had received this income directly, and not through the conduit of the partnership."	"* * * when the partnership return shows net income, a partner's distributive share is to be entered in his own return as his own income derived from the partnership without retaining the peculiar character it had in the partnership return unless Congress has expressly so provided and then only for the purpose stated."

It is respectfully submitted that the Court should now grant certiorari without waiting for the decision of the Court of Claims in the *Central Hanover* case.

I.

Conflict between the decision below and the *Craik* case with respect to the commission question.

On this point the facts are briefly as follows: During 1932 petitioner, a member of the New York Stock Exchange whose business was trading in securities for himself, for his partnership and for its customers, paid commissions on the purchase of securities to his partnership. These commissions were included by the partnership in its income tax return and 45% of the commissions, that being petitioner's share of his firm's income, were in turn included in petitioner's own income tax return and taxed to him. Petitioner sought deduction of the entire amount of purchase commissions paid in 1932 as an expense of his business of trading in securities. After the Board's decision allowing such deduction, this Court decided that, under Regulations of the Commissioner of long standing, purchase commissions were not deductible as such. *Helvering* v. *Winmill,* 305 U. S. 79.

In the Circuit Court of Appeals, petitioner contended that he should not be subjected to an income tax on that share of the purchase commissions which were repaid to him in the same year in his distributive share of the partnership income, since to that extent he had in effect paid the commissions to himself, and if not deductible as commissions paid, the portion returned to him should not be taxed as income received. The Government, arguing that the commissions lost their identity when received by the partnership and that petitioner was taxable on his full distributive share without reference to the sources of the partnership income, was sustained.

The rule of the *Craik* case is summarized by the Court of Claims thus:

> "An examination of the various income tax Acts, beginning with the first one of 1913, shows that Congress in the enactment of each of them intended to treat partnership income as though the distributive share of each partner therein had been received *directly* by the partner." (Emphasis supplied.)

Under this rule petitioner here must be deemed to have received directly from himself 45% of the purchase commissions, that being his share of the firm's income, and of course he should not be subjected to income tax on his own money. The decision of the Court below to the contrary cannot be reconciled with the *Craik* case.

The rule of the *Craik* case quoted above was no casual dictum. It was the heart of the decision. Craik was a member of a domestic partnership which received income from domestic and foreign sources. Being a non-resident alien, Craik would not have been taxable upon foreign income received by him directly. However, the partnership provisions of the Federal Income Tax Law provided that every partner should be taxable on "his distributive share, whether distributed or not, of the net income of the partnership for the taxable year".

There was no provision exempting non-resident alien members of domestic partnerships from income tax on that part of the partnership income derived from foreign sources.

Thus the Court of Claims was squarely presented in the *Craik* case with the question whether partners may be deemed to have received directly their proportionate shares of each item of the partnership income received by the partnership even in the absence of any provision in the Income Tax Law to that effect. In so holding, the Court of Claims pointed out:

> "The income earned by the partnership was regarded as having been earned by each of the individual partners, either by himself individually or through his agents, the other partners.
>
> "The Bureau of Internal Revenue has so treated partnership income for twenty years. Originally it promulgated a regulation providing that partnership income could not be traced to its source behind the partnership for the purpose of claiming individual exemption. This ruling, however, was questioned and presented to the District Court for the Northern District of Ohio. On June 26, 1918, the Court rendered an opinion holding that the Revenue Acts treat a partnership's—
>
> > '* * * profits and its earnings as those of the individual taxpayer. * * * The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name' (251 Fed. 982).
>
> "This case was affirmed on appeal. *United States* v. *Coulby*, 258 Fed. 27.

> "It is admitted that since this time partnership income has been so treated by the Bureau. In the light of this administrative practice Congress has continued to enact substantially the same provisions for the treatment of partnership income."

Had the court below applied the same rule, it could not have taxed petitioner on his proportionate share of the purchase commissions, since, under the *Craik* case, petitioner must be deemed to have paid these commissions directly to himself to the extent of his 45% interest in the partnership. No one has yet suggested that the income tax goes so far as to tax an individual on the transfer of his own funds from one of his pockets to another.

II.

Conflict between the decision below and the *Craik* case with respect to the security profits question.

In the course of his business of trading in securities for himself and for his partnership, petitioner realized individual losses in 1932 upon the sale of securities held less than two years. For his partnership, his trading produced profits on the sale of securities held less than two years. On his return, petitioner sought to set off his individual security losses against his share of the partnership's security profits. The court below held that he could not do this, citing its prior decision by a divided court (Judge Swan dissenting) in *Johnston* v. *Commissioner,* 86 F. (2d) 732.

Before 1932 losses on securities held less than two years were fully deductible from all types of income,

including a partner's share of his firm's security profits. In 1932, the statute was amended in Section 23(r) to provide that losses from sales of securities held less than two years shall be allowed only to the extent of profits from such sales. If petitioner had realized directly his share of his partnership's security profits in 1932, the 1932 law would have permitted him to reduce the profits by the losses. Petitioner took the position that, to the extent of his interest in his partnership, he was entitled to consider its security profits as being his. In this view his share of the partnership's security profits and his individual security losses could be segregated together, only the excess profits being subjected to income tax.

The Commissioner said that this could not be done, urging that, in the absence of a specific provision authorizing a partner to treat his share of the partnership income as having been received directly by him, the partnership income lost its character and became general income. As general income, its component parts could not be lumped with the component items on the individual's return.

This was a departure from the twenty year old administrative practice of the Bureau (referred to in the *Craik* case) of treating the partner's share of the firm's items of income as having been received directly by him. It was not justified by any specific provision in the 1932 Act. Section 23(r), which limited security losses to security profits, made no reference to partnerships, and the partnership sections of the Income Tax Law were carried over from the earlier Acts into the 1932 Act without change. Nevertheless the court below, Judge Swan dissenting,

accepted the Commissioner's view, and held in the *Johnston* case (86 F. (2d) at 734):

> "* * * when the partnership return shows net income, a partner's distributive share is to be entered in his own return as his own income derived from the partnership without retaining the peculiar character it had in the partnership return unless Congress has expressly so provided and then only for the purpose stated."

Since the decision of the Court below in the instant case was rendered *per curiam* on the authority of the *Johnston* case, it is clear that on this point as well as on the commission point there is a direct conflict with the *Craik* case. It is true that in the *Craik* case the Court made a half-hearted attempt to justify the *Johnston* decision. It is submitted, however, that the attempt is hollow, and that, read as a whole, the opinion in the *Craik* case cannot be squared with the *Johnston* decision. The Court of Claims said:

> "The Court [in the *Johnston* case] thought that Congress, by providing for certain specific credits against a partner's income on account of his share of partnership profits, thereby impliedly prohibited any other credit. The Court called attention to the fact that the Act expressly provided for taxing the partners on their distributive share of capital net gains as if it had been received by them individually, and thought that its failure to mention noncapital gains and losses indicated that it did not intend that they should be treated similarly. This case was followed by this court in *Klingenstein* v. *United States,* 85 C. Cls., 164; 18 F. Supp. 1015.
>
> "Congress' attention having been given to

gains and losses, and having provided for the treatment of capital gains and losses as if they were the gains and losses of the individual partners, and not having made such provision for noncapital gains and losses, there was room for the conclusion reached in the *Johnston* case, *supra.*"

Having said so much, the Court then proceeded to demolish its support of the *Johnston* case as follows:

"But we do not think that by the specification of certain items for which the partner might take credit Congress intended to exclude all others, if the exclusion of them would result in the treatment of partnership income in a way different from what it would have been treated had it been received by the partners individually.

"It is, of course, within the power of Congress to limit deductions from gross income to any extent it pleases, but our study of the pertinent sections of the 1916 and 1918 Acts and of related sections of other acts persuades us that Congress intended that an individual should have every deduction from partnership income which he might take from his individual income, unless the contrary clearly appears.

"However, we are dealing here not with what credits or deductions a partner is entitled to, but what he shall include in his gross income. We are convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually. If we are correct in this, then this plaintiff's proportionate share of the partnership income received from sources without the United States

should be treated as though he himself had received this income directly, and not through the conduit of the partnership. If so, in computing his income, his proportionate share of the income from sources without the United States should be excluded.

"The defendant further takes the position in its brief that the plaintiff received his income from the partnership, and since the partnership was a 'domestic partnership' his income was from sources within the United States, from whatever source the income might have been derived by the partnership. This cannot be true unless the partnership is regarded as a separate entity, and this the Revenue Act does not do. (*Cf. Dorothy S. Bence* v. *United States,* 84 C. Cls., 605; 18 F. Supp. 848.)"

Just how squarely the *Craik* and *Johnston* cases are in conflict is shown by the following two subjoining excerpts from the opinions of the two Courts, each setting forth in one sentence the basis of its holding:

Craik

"It is, of course, within the power of Congress to limit deductions from gross income to any extent it pleases, but our study of the pertinent sections of the 1916 and 1918 Acts and of related sections of other acts persuades us that Congress intended that an individ-

Johnston

"* * * when the partnership return shows net income, a partner's distributive share is to be entered in his own return as his own income derived from the partnership without retaining the peculiar character it had in the partnership return unless Congress has ex-

Craik	*Johnston*
ual should have *every* deduction from partnership income which he might take from his individual income, unless the contrary clearly appears." (Emphasis supplied.)	pressly so provided and then only for the purpose stated."

If the Court of Claims had believed that the argument in the *Johnston* case was sound that a partner should not be given credit for his share of specific items of the partnership income except where the Revenue Act expressly so provided, it could not have held for the plaintiff in the *Craik* case, since there was no specific provision in the Act giving a nonresident alien partner credit for his share of the partnership's foreign income while there were specific provisions in the Act giving a partner credit for his share of various other kinds of partnership income, such as dividends and Government bond interest.

It is submitted that the conflict in the present case is no less sharp and of no less importance than other tax cases in which certiorari was granted this Term, such as *Higgins* v. *Smith* (a loss case; conflict with *Griffiths* v. *Helvering,* a gain case) and *Real Estate Land Title Co.* v. *United States* (obsolescence through voluntary disuse; conflict asserted with *Crooks* v. *Kansas City Title Co.,* obsolescence through functional inefficiency).

Conclusion.

It is submitted that the *Craik* case is in conflict with the decision below with respect to the proper

treatment for Federal income tax purposes of partnership income. As pointed out in the petition for certiorari in this case, at least seven different situations have arisen in which the question how to treat partnership income on the individual partners' returns is decisive. The *Craik* case represents an eighth situation not mentioned in the petition for certiorari, and no doubt there are others. Since the decision below conflicts with uniform administrative practice for twenty years and conflicts with the decisions both of the Court of Claims and of the Sixth Circuit (in the *Coulby* case) with regard to the treatment of partnership income, it is submitted that certiorari should be granted now.

However, if the Court is not inclined to grant certiorari at this time, petitioner respectfully moves that the Court defer consideration of the petition for rehearing until the decision of the Court of Claims in the *Central Hanover Bank* case, which raises the identical questions regarding commissions and security profits which are in the instant case. Counsel for the petitioner here has discussed the *Central Hanover* case with Government counsel, and is authorized to state that every effort is being made to have the *Central Hanover* case argued before the Court of Claims at its April sitting. If the Court prefers to withhold action on the petition for rehearing herein until the decision in the *Central Hanover* case, the Government will not be prejudiced by the delay since the tax in this case has been paid.

Respectfully submitted,

JOSEPH M. PROSKAUER,
WALTER MENDELSOHN,
WILBUR H. FRIEDMAN,
Counsel for Petitioner.

February, 1940.

Appendix.

John Craik v. *U. S.*

(U. S. Court of Claims, No. M-79, February 5, 1940)

OPINION

Whitaker, Judge, delivered the opinion of the court:

The plaintiff during the time in question was a nonresident alien. He was a member of two partnerships operating in this country. Both of these partnerships derived a portion of their income from sources without the United States. The plaintiff, being a nonresident alien, claims the right to exclude from his income his distributive share of the partnership income derived from sources without the United States, under section 213(c) of the Revenue Act of 1918, which reads in part as follows:

> "In the case of nonresident alien individuals, gross income includes only the gross income from sources within the United States, * * *"

and a similar provision of the Revenue Act of 1916 [section 1(a)].

The provisions of the Revenue Act of 1916, as amended, and of the Act of 1918 applicable here are substantially the same. Section 218(a) of the Revenue Act of 1918 provides:

> That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

It then provides that each partner, in computing his net income, shall include "his distributive share, whether dis-

tributed or not, of the net income of the partnership * * *."

In subsection (d) the method of computing the net income of the partnership is prescribed. It is provided that it "shall be computed in the same manner and on the same basis as provided in section 212, except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed." The paragraph referred to is that permitting deductions for charitable and similar contributions.

Since the partnership in computing its net income was required to include, as was an individual, dividends received from corporations and interest on United States obligations, and since an individual in computing his income subject to normal tax was entitled to deduct such items, it was provided that a partner might deduct from his income his proportionate share of such interest and dividends received by the partnership.

An examination of the various income tax Acts, beginning with the first one of 1913, shows that Congress in the enactment of each of them intended to treat partnership income as though the distributive share of each partner therein had been received directly by the partner. Each one of the Acts contains the statement that "individuals carrying on business in partnership shall be liable for income tax only in their individual capacity," and each one of them allows the partner the same credit against partnership income to which he was entitled against his individual income.

The 1913 Act did not in terms allow the credits allowed by the 1918 Act. This, undoubtedly, was because Congress had the common-law view of a partnership and, therefore, did not think it necessary to enact such an ex-

press provision, assuming that it would be understood that the income of the partnership was intended to be treated as that of the individual partners.

In the enactment of the Revenue Act of 1916, however, Congress made express provision for the exclusion from the individual partner's income of that part of his proportionate share of the partnership income which would have been excluded had the income been received by him individually, such as interest on United States obligations, or those of a State or political subdivision thereof, taxes paid to the United States, or to any State or political subdivision, and their proportionate share of dividends received by the partnership; thus more fully expressing its intent that the partnership should not be treated as a separate entity, but that income received by it should be treated as income received by the individual partner.

A different method for the handling of partnership income was provided for in the 1918 Act. By that Act rules were laid down for the computation of the partnership income, whereas none had been in either the 1913 or 1916 Acts. A partnership was required to compute its income as did an individual, but in order to treat the partner's distributive share thereof on the same basis as his individual income, the credit for his proportionate share of dividends and interest on United States obligations was expressly allowed him. This indicates to us again that Congress intended to treat partnership income as income received by the individual partners.

The 1921, 1924 and 1926 Acts contained the same provisions as the 1918 Act.

The 1928 Act allowed an individual credit for earned income and allowed him to compute capital net gains and

losses on a basis different from ordinary gains and losses. So, continuing its policy of treating a partner's distributive share of partnership income on the same basis as income received by him individually, it was provided that a partner should be entitled to credit for his proper part of the partnership's earned income, and that his proper part of the partnership's capital net gains and losses and of its ordinary net income should be taxable to him as though they had been received by him directly. The partner was also permitted to deduct his proportionate share of the net loss of the partnership and his proportionate share of income, war-profits, and excess-profits taxes paid foreign countries.

The 1932 Act was to the same effect.

Only in one respect might it be said that Congress had evinced a purpose not to treat partnership income as income received by the individual partners. That is, that partnerships in computing their income were not entitled to deduct charitable contributions; whereas individuals were. But the Bureau of Internal Revenue held, after this restriction had been placed on partnerships in the 1918 Act, that the respective partners were entitled to the deduction in computing their individual income. O.D. 185, 1 C.B. 151. After this ruling was made Congress enacted the 1921, 1924, 1926, 1928, and 1932 Acts and made no change in the law, thus evidencing its approval of this ruling, and thus further evidencing its intention that a partner's distributive share should be treated as though it had been received by him individually.

In the 1934 and 1936 Acts the prohibition against the deduction of charitable contributions in computing the income of partnerships was eliminated. The 1938 Act prohibited the deduction to the partnership, but per-

mitted the partners to deduct their proportionate share, going back to the practice established when the 1918 Act was passed.

The treatment of partnership income on the same basis as though it had been received by the partner directly is consistent with the common-law idea of a partnership. At common law, the personal property of the partnership was held not by the partnership, but by the partners in common. Real estate was held by an individual for the benefit of the partnership, because a partnership was not an entity and, therefore, could not hold the title. Each partner was liable for the debts of the partnership on the theory that they were the partners' debts and not the debts of the partnership. Each partner was the agent for the other partners in the carrying out of their common purpose. The income earned by the partnership was regarded as having been earned by each of the individual partners, either by himself individually or through his agents, the other partners.

The Bureau of Internal Revenue has so treated partnership income for twenty years. Originally it promulgated a regulation providing that partnership income could not be traced to its source behind the partnership for the purpose of claiming individual exemption. This ruling, however, was questioned and presented to the District Court for the Northern District of Ohio. On June 26, 1918, the court rendered an opinion holding that the Revenue Acts treat a partnership's—

> * * * profits and its earnings as those of the individual taxpayer. * * * The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same foot-

> ing as if his income had been received directly by him without the intervention of a partnership name. (251 Fed. 982.)

This case was affirmed on appeal. *United States* v. *Coulby*, 258 Fed. 27.

It is admitted that since this time partnership income has been so treated by the Bureau. In the light of this administrative practice Congress has continued to enact substantially the same provisions for the treatment of partnership income.

The defendant, however, presses upon us the decision of the Second Circuit Court of Appeals in *Johnston* v. *Commissioner of Internal Revenue*, 86 F. (2d) 732 [18 A.F.T.R. 662], Circuit Judge Swan dissenting. In that case the majority of the court held that a partner was not permitted to offset his noncapital net loss against his proportionate share of the partnership net gain. The Court thought that Congress, by providing for certain specific credits against a partner's income on account of his share of partnership profits, thereby impliedly prohibited any other credit. The Court called attention to the fact that the Act expressly provided for taxing the partners on their distributive share of capital net gains as if it had been received by them individually, and thought that its failure to mention noncapital gains and losses indicated that it did not intend that they should be treated similarly. This case was followed by this court in *Klingenstein* v. *United States*, 85 C. Cls., 164; 18 F. Supp. 1015.

Congress' attention having been given to gains and losses, and having provided for the treatment of capital gains and losses as if they were the gains and losses of the individual partners, and not having made such pro-

vision for noncapital gains and losses, there was room for the conclusion reached in the *Johnston* case, *supra*. But we do not think that by the specification of certain items for which the partner might take credit Congress intended to exclude all others, if the exclusion of them would result in the treatment of partnership income in a way different from what it would have been treated had it been received by the partners individually.

It is, of course, within the power of Congress to limit deductions from gross income to any extent it pleases, but our study of the pertinent sections of the 1916 and 1918 Acts and of related sections of other acts persuades us that Congress intended that an individual should have every deduction from partnership income which he might take from his individual income, unless the contrary clearly appears.

However, we are dealing here not with what credits or deductions a partner is entitled to, but what he shall include in his gross income. We are convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually. If we are correct in this, then this plaintiff's proportionate share of the partnership income received from sources without the United States should be treated as though he himself had received this income directly, and not through the conduit of the partnership. If so, in computing his income, his proportionate share of the income from sources without the United States should be excluded.

The defendant further takes the position in its brief that the plaintiff received his income from the partnership, and since the partnership was a "domestic partnership" his income was from sources within the United

States, from whatever source the income might have been derived by the partnership. This cannot be true unless the partnership is regarded as a separate entity, and this the Revenue Act does not do. (Cf. *Dorothy S. Bence* v. *United States,* 84 C. Cls., 605; 18 F. Supp. 848.)

It results that the plaintiff is entitled to recover the amounts stipulated, to wit: $2,671.65 with interest at 6 percent from June 15, 1918; $6,508.14 with interest at 6 percent from December 15, 1919; and $2,186.15 with interest at 6 percent from December 15, 1920. It is so ordered.

Williams, Judge; Littleton, Judge; Green, Judge; and Whaley, Chief Justice, concur.